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# Program Evaluation

## Internal Controls Over Corporate Income Tax Credits Georgia Department of Revenue

**Performance Audit Operations Division**  
**Georgia Department of Audits and Accounts**

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**Report 05-08**

### **Improved internal controls are needed in the administration of corporate tax credits; data for evaluating their cost and benefit to the state should be compiled.**

As a result of having limited internal controls over its review of tax credits and record-keeping, the Department of Revenue (DOR) cannot ensure that the credits have been accurately and consistently earned and used. In addition, DOR does not and is not required to maintain or report information needed to assess the credits' fiscal impact. It is estimated that Georgia has forgone at least \$284.5 million<sup>1</sup> in income tax revenue through corporate tax credit use from 1999 through 2004 without any indication of how it has benefited from these tax expenditures.

#### **Internal Control Weaknesses:**

- DOR lacks standard guidelines needed to ensure that tax credits are being administered in accordance with state law and departmental regulations.
- The information and documentation that taxpayers are required to provide in support of tax credit-qualifying activities are limited, with DOR staff relying on taxpayer certifications that tax credit requirements have been met.
- DOR does not conduct periodic reviews of staff decisions regarding the approval, denial, and calculation of credits to ensure their accuracy and consistency.
- While audits of corporate income taxpayers serve as an important control, only a small proportion of tax credits are audited in a given year.
- DOR lacks a centralized information system with appropriate controls needed to maintain data and to monitor the use of tax credits; the fragmented nature of the data management systems has prevented complete and accurate compilation of basic data regarding tax credits.

In its response, DOR indicated that it will take steps to address the internal control deficiencies identified in this report.

<sup>1</sup> Represents unaudited dollar value of used credits for 12 of the 13 credits reviewed as part of this evaluation.

### **Purpose of Review**

The primary purpose of this evaluation was to determine if there are adequate internal controls over the administration and processing of Georgia's corporate income tax credits by the Department of Revenue (DOR). Controls were assessed for a sample of 13 corporate income tax credits designed to recruit and expand business in the state.

Specifically, the evaluation addressed questions concerning whether DOR is administering the tax credits in the most efficient and effective manner; the extent to which DOR is consistently and accurately awarding tax credits to businesses; and whether DOR collects and reports adequate data needed to make management, legislative, and budgetary decisions.

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## Background

### Georgia's Corporate Tax Credits

Tax credits reduce the amount of tax that businesses owe the state in exchange for the businesses' completion of certain activities. These activities are generally designed to promote economic development by creating a favorable environment for business relocation, retention, and expansion, and by improving the state's economic competitiveness relative to other states.

**Tax credits** reduce the amount of tax businesses owe the state in exchange for such things as the creation and retention of jobs, the provision of basic skills education to workers, and the construction or expansion of manufacturing facilities.

Although the criteria for eligibility vary for each credit, Georgia's corporate income tax credits are generally available to businesses engaged in manufacturing, tourism, research and development, warehousing and distribution, processing, and telecommunications. The types of entities eligible to earn tax credits include corporations, S-corporations (shareholder corporations), partnerships, sole proprietors, limited liability companies, and limited liability partnerships. The tax credits provide incentives for completing a range of activities such as the creation and retention of jobs, the provision of basic skills education to employees, and the purchase of property used to create or expand a business facility. Some tax credits are targeted to selected industries and/or are dependent on the county in which qualifying activities occur. The economic development objectives of tax credits generally include the following:

- Job creation and retention; reduction in unemployment; and multiplier effects of new jobs (subsequent increases in employment and eventual increase in state revenue)
- Improvement of job quality (higher wages or better benefits)
- Reduction of intra-state economic welfare disparities (i.e., across counties and/or regions)
- Recruitment of specific industries
- Improvement of the state's fiscal condition through greater tax revenues

Each tax credit is defined in statute, which provides the dollar amount of the credit, the general eligibility requirements, and the length of time over which the credit can be claimed and used. Several tax credits have a total dollar limit and/or their use is limited to a set proportion of businesses' income tax liability. In many cases, tax credits can be carried forward for use in subsequent tax years. Some tax credits allow businesses to transfer income tax credits for use against withholding tax obligations if a business has no income tax liability remaining after applying the tax credits.

In addition, credits earned by businesses may be transferred between parent companies and subsidiaries (referred to as credit “assignment”) and, in the case of businesses with shareholders (e.g., S-corporations), the credits are transferred to each shareholder in an amount proportional to their percentage ownership (referred to as credit “pass through”). Credits can also be claimed on amended tax returns for up to three years following the year in which the credit was earned.

State statute does not require DOR or the other administering agencies to collect or report data regarding tax credits and their impact. Regulations established by the Department of Community Affairs (DCA) require DOR to provide an annual report that details, by county, the number of jobs created by the Job Tax Credit and the amount of credit used.

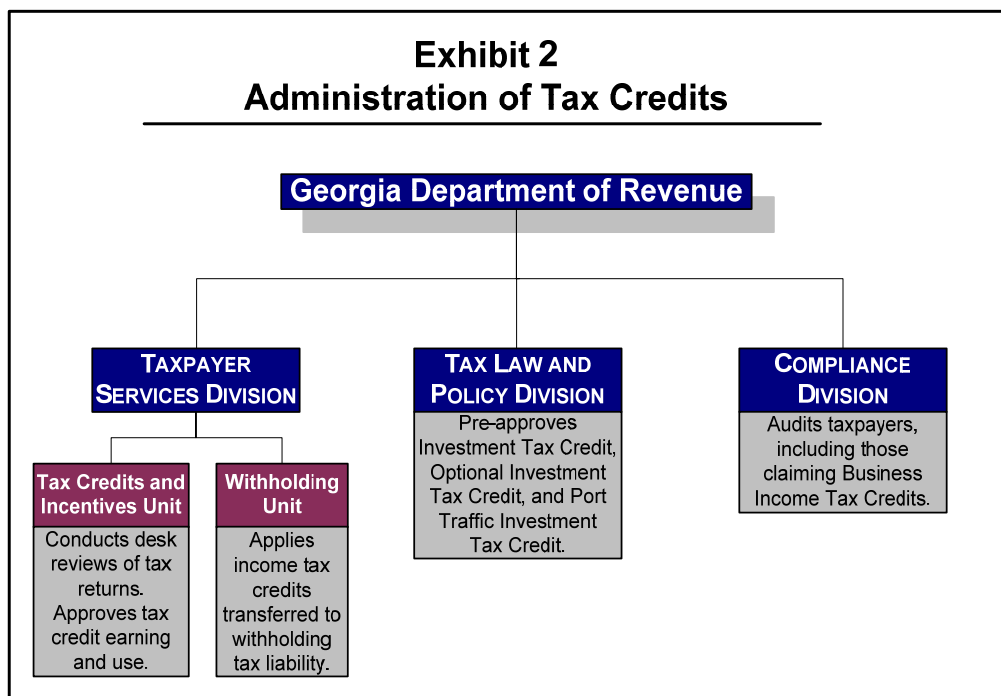
At the time of the audit, 24 income tax credits were administered by DOR. A description of the 13 credits included in the scope of this evaluation is provided in **Exhibit 1** on the following page.

<b>Exhibit 1</b> <b>Descriptions of Corporate Tax Credits Reviewed</b>	
<b>Basic Skills Education Tax Credit</b>	Provided to employers who provide or sponsor education programs that enhance reading, writing, or mathematic skills up to a twelfth-grade level. Training must be certified by the Department of Technical and Adult Education. Calculated per full-time student. <i>O.C.G.A. 48-7-41</i>
<b>Cigarette Export Tax Credit</b>	Provided to businesses that export cigarettes to a foreign country. Calculated by volume of cigarettes exported. <i>O.C.G.A. 48-7-40.20</i>
<b>Headquarters Job Tax Credit</b>	Provided to businesses that establish headquarters in or relocate headquarters to Georgia. Business must meet thresholds for number of jobs created, property cost, and wages of new jobs. Awarded per new full-time job; amount varies based on average wage of new employees. <i>O.C.G.A. 48-7-40.17; 48-7-40.18</i>
<b>Job Tax Credit</b>	Provided to businesses that create a set minimum number of new jobs in underdeveloped counties. Calculated per new full-time job and ranges based on the economic status of the county in which the business is located. Additional credit available if jobs are created within a joint development authority. <i>O.C.G.A. 48-7-40; 48-7-40.1; 48-7-40.21; 36-62-5.1</i>
<b>Manufacturer's Investment Tax Credit</b>	Provided to manufacturing and telecommunications facilities that have operated in Georgia for at least three years and have purchased, acquired, or leased property to construct additional facilities or expand a facility. Property cost must meet a minimum threshold. Calculated by cost and location of property. <i>O.C.G.A. 48-7-40.2; 48-7-40.3; 48-7-40.4</i>
<b>New Manufacturing Facilities Job Tax Credit</b>	Provided to manufacturing businesses that plan to construct a new manufacturing facility or expand a manufacturing facility in the state. Must meet property cost and job creation thresholds. Calculated per new full-time employee. <i>O.C.G.A. 48-7-40.24</i>
<b>New Manufacturing Facilities Property Tax Credit</b>	Provided to manufacturing businesses that have operated a manufacturing facility in Georgia for at least the last three years and are planning to create a new facility. Must meet property purchase and employment threshold. Credit amount equal to a percentage of the property cost. <i>O.C.G.A. 48-7-40.25</i>
<b>Optional Investment Tax Credit</b>	Provided to manufacturing and telecommunications facilities that have purchased, acquired, or leased property to construct additional facilities or expand facilities. Property cost must meet a minimum threshold. Calculated by cost and location of property. <i>O.C.G.A. 48-7-40.7; 48-7-40.8; 48-7-40.9</i>
<b>Port Traffic Job Tax Credit</b>	Provided to businesses that meet thresholds for port traffic increase and jobs created. Awarded per job and is in addition to Job Tax Credit. <i>O.C.G.A. 48-7-40.15</i>
<b>Port Traffic Investment Tax Credit</b>	Provided to businesses that increase port traffic by a specified amount and that purchase or acquire qualified investment property meeting a minimum cost. Calculated by cost of property. <i>O.C.G.A. 48-7-40.15</i>
<b>Research Tax Credit</b>	Provided to businesses with qualified research expenses. Credit amount based on a business' net taxable income and its research expenses. <i>O.C.G.A. 48-7-40.12</i>
<b>Retraining Tax Credit</b>	Provided to employers who provide/sponsor training for the use of new technology. Department of Technical and Adult Education must approve training. Calculated per full-time employee receiving training. <i>O.C.G.A. 48-7-40.5</i>
<b>Rapid Growth Tax Credit</b>	Provided to small businesses whose net taxable income meets an annual growth threshold. Amount is a percentage of annual growth. <i>O.C.G.A. 48-7-40.15</i>

## Administration of Tax Credits

DOR is responsible for administering and auditing tax credits claimed on businesses' income tax returns. Two state agencies assist with the Department's administration of the credits. DCA annually designates a tiered ranking of all Georgia counties based on each county's unemployment rate, per capita income, and percentage of residents whose incomes are below the poverty level; the tiers are then used to calculate certain tax credits. The Department of Technical and Adult Education (DTAE) certifies retraining programs for which businesses can receive a tax credit. In addition, DCA and DTAE, by statute, have roles in defining the entities and/or activities that are eligible for income tax credits.

As shown in **Exhibit 2**, DOR's Divisions of Taxpayer Services (TPS), Tax Law and Policy (TLP), and Compliance are involved in the administration and oversight of these tax credits. The Tax Credits and Incentives Unit within TPS receives all income tax returns on which tax credits are claimed and is responsible for reviewing all but one of the credits. (An individual in TLP reviews the Headquarters Job Tax Credit.)



Three of the tax credits (the Manufacturer's Investment Tax Credit, the Optional Investment Tax Credit, and the Port Traffic Investment Tax Credit) require pre-approval by DOR before they can be claimed on a business' tax

return. These credits are pre-approved by a tax policy analyst in TLP. Two tax credits, the Basic Skills Tax Credit and the Retraining Tax Credit, require DCA pre-approval of qualifying activities.

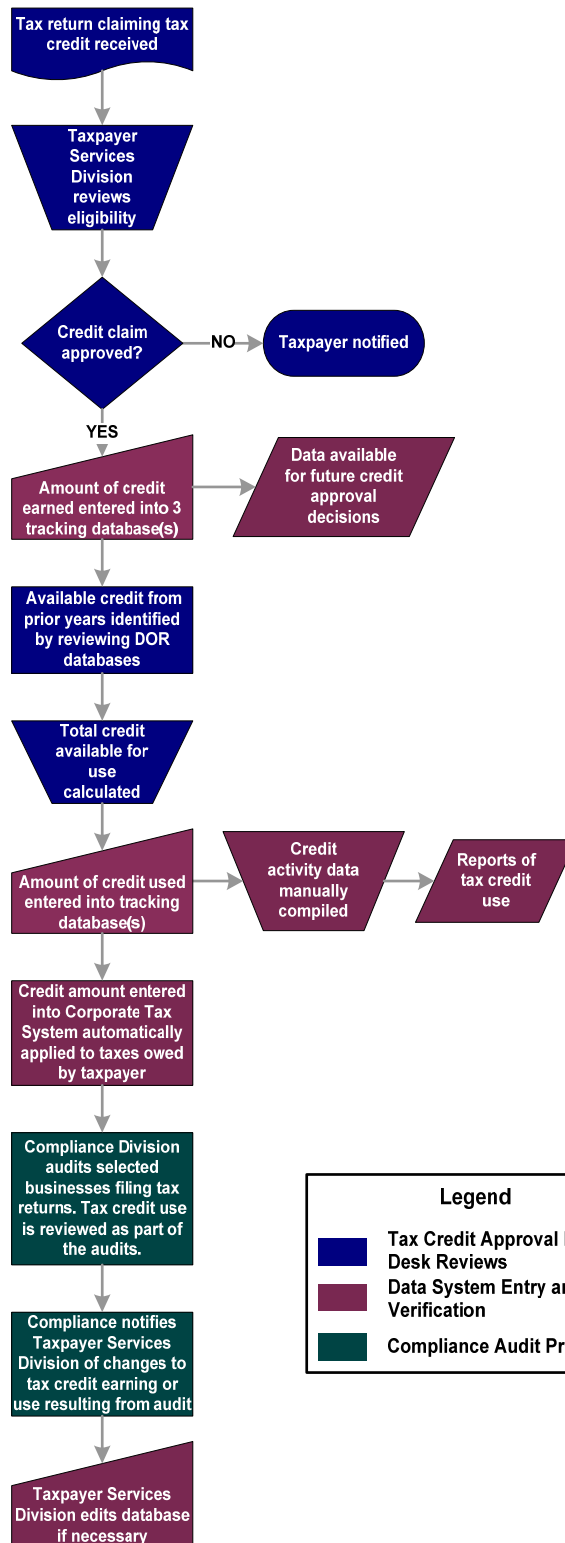
As shown in **Exhibit 3** on page 7, DOR's administration of tax credits generally begins with businesses claiming tax credits by submitting various forms and schedules with their corporate income tax returns. The returns and accompanying forms and schedules contain general information about the type of business, the activities completed for tax credit eligibility, and the business' calculation of the amount of credit earned and available for use. Some of these calculations may include carry-forward credit(s) (i.e., tax credits earned in prior tax years that have not yet been used).

"Desk reviews" of tax returns are conducted by TPS staff, which primarily include confirming the presence of required forms and correct calculations. The reviewer relies on taxpayer-reported information or taxpayer certification of compliance with requirements to approve or disapprove claims for credit(s). If needed, additional supporting documentation may be requested from the taxpayer or the claim may be denied.

Once a decision has been made to approve or deny the credit, the approved credit amount is entered into the Corporate Tax System and an Excel database maintained by the Tax Credits and Incentives Unit (see data management section on page 8 for a description of DOR's data systems). Unit staff also must determine if carry-forward credits from prior years exist and the amount of credit that can be utilized in the current year. If the credits are assigned to affiliated entities or passed through to shareholders, Unit staff are responsible for recording this information as well.

Businesses are generally audited by DOR's Compliance Division on a three-year cycle. During an audit, a business' use of an income tax credit is reviewed. Although businesses are not selected for an audit based on having claimed an income tax credit, Division staff indicated that businesses with larger tax liabilities are audited more frequently, and that these businesses typically are those that use tax credits.

### Exhibit 3 Tax Credit Administration Process

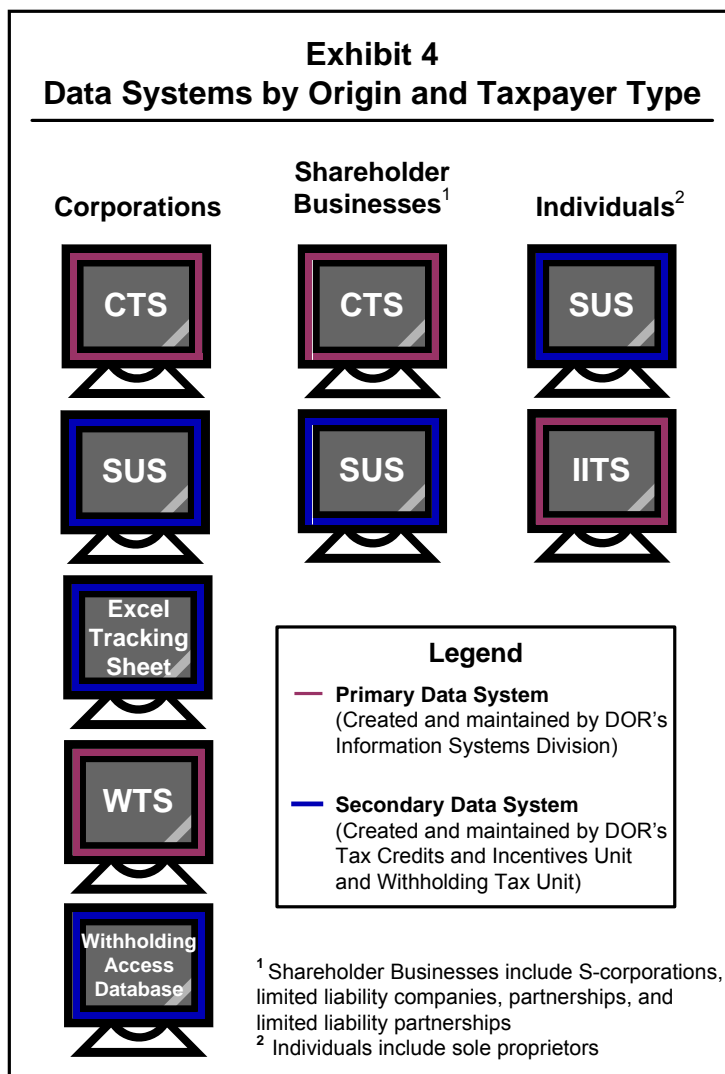


## Data Management

DOR uses six systems to record and maintain data regarding tax credits: the Corporate Tax System (CTS), Excel Tracking Sheets, Shareholder Utilization Schedules (SUS's), the Individual Income Tax System (IITS), the Withholding Tax System (WTS), and the Withholding Access Database. These systems maintain records of three types of taxpayers: corporations, shareholder businesses (businesses with shareholders, partners, or members), and individuals. See **Exhibit 9** on page 30 for a summary of the taxpayers whose information is maintained in each system.

As shown in **Exhibit 4**, three of the data systems — CTS, WTS, and IITS — are official (primary) data systems created by DOR's Information Systems Division. The other three (secondary) data systems — Excel Tracking Sheets, SUS's, and the Withholding Access Database — were created by TPS staff involved in administering the credit based on a perceived need to either maintain data not captured in DOR's official data systems or to simplify the tax credit approval process.

The Department uses CTS to record credits that are available for use against a business' income tax liability and determine how much tax a business owes the state. CTS automatically generates assessments for additional taxes





owed because of underpayment by the taxpayer (in some cases due to a business claiming more tax credit than it is allowed to use). CTS contains information regarding businesses and does not include that of individual taxpayers who may claim a credit as a shareholder. WTS contains information regarding businesses that pay withholding tax and any related tax credits applied to this liability, and IITS contains information regarding individual taxpayers (including shareholders) who pay income tax and any tax credits applied to this liability. These three systems are located on the Department's network.

Staff within the Tax Credits and Incentives Unit have developed two secondary, "off-line" data systems that are only used and accessed by Unit staff through a shared drive within the Taxpayer Services Division: Excel Tracking Sheets and Shareholder Utilization Schedules (SUS's). Excel Tracking Sheets maintain information regarding tax credit use and carry-forward by businesses. SUS's contain information regarding credit earned by shareholder businesses and credit use by their shareholders, as well as credit amounts carried forward for future use. The Withholding Unit has also developed an off-line system, the Withholding Access Database, which contains information regarding the credit approval status of all businesses applying to use income tax credits against their withholding tax liability.

### Staffing and Cost of Administration

The cost of administering business tax credits is not separately accounted for by DOR. As noted previously, the credits are administered by various individuals in multiple divisions within DOR. Based on a review of staff time spent administering credits, the audit team estimated the Department's cost of administering corporate income tax credits in fiscal year 2006 to be approximately \$381,088, with Taxpayer Services Division staff accounting for 51% of the cost. **Exhibit 5** shows the estimated annual cost of administering tax credits by division.

<b>Exhibit 5</b>	
<b>Estimated Cost of Administering Tax Credits, Fiscal Year 2006</b>	
<b>Taxpayer Services Division</b>	
Salaries	\$146,131
Benefits	47,142
<i>Subtotal</i>	\$193,273
<b>Tax Law and Policy Division</b>	
Salaries	\$74,190
Benefits	23,934
<i>Subtotal</i>	\$98,124
<b>Compliance Division</b>	
Salaries	\$67,814
Benefits	21,877
<i>Subtotal</i>	\$89,681
<b>TOTAL</b>	<b>\$381,088</b>

This estimate includes the salaries and benefits of 23 DOR staff who reported being involved in the administration of corporate tax credits, and has been adjusted for the percentage of time they reported spending on the administration of tax credits. The 23 staff are located in the Department's Compliance, Taxpayer Services, and Tax Law and Policy Divisions.

## Activity Data

According to data provided by DOR, the value of the 13 income tax credits reviewed was nearly \$379 million from 1999-2003.<sup>1</sup> The amount of credit used by credit type can be found in **Exhibit 6**. It is important to note that these tax credit figures are unaudited and could not be verified by the audit team. The figures exclude the use of pass-through credit (used by individual taxpayers who are shareholders of businesses earning tax credits), and therefore understate the actual amount of credit that has been used; however, the extent of this understatement is unknown. These figures also do not include substantial amounts of credit that have been carried forward for use in future years. For example, in 2002, the total amount of tax credit that had been carried forward was approximately \$195.8 million. See page 31 for a discussion of the accuracy of Department-reported figures.

<b>Exhibit 6</b>		
<b>Tax Credit Use, Calendar Years 1999-2003 (as of 1/1/06)</b>		
<b>Credit Type</b>	<b>Number of Businesses</b>	<b>Credit Used</b>
Retraining Tax Credit	304	\$98,652,479
Job Tax Credit*	416	94,331,722
Port Traffic Investment Tax Credit	9	57,298,386
Investment Tax Credit	264	39,670,369
Cigarette Export Tax Credit	3	22,033,539
Research Tax Credit	91	21,490,937
Port Traffic Job Tax Credit	6	20,615,401
Headquarters Job Tax Credit	4	19,185,000
Rapid Growth Tax Credit	35	3,991,470
Optional Investment Tax Credit	2	1,639,801
Basic Skills Tax Credit	4	10,660
<b>Total Credit Used</b>		<b>\$378,919,764</b>
*Job Tax Credit includes credit used by 15 businesses against withholding tax liability		
<b>[Note:</b> This table excludes two credits that had not been used as of the date of publication: the New Manufacturing Facilities Job Tax Credit and New Manufacturing Facilities Property Tax Credit.]		
Source: DOR Records		

<sup>1</sup> Credits can be claimed on amended tax returns for up to three years following the year in which the credit was earned. As a result, this amount may be greater once all returns have been filed. This figure also does not include credit used by individual taxpayers.

As shown in **Exhibit 6**, the Job, Investment, and Retraining Tax Credits were used by the largest number of businesses. Of the 13 credits, the Retraining, Job, and Port Traffic Investment Tax Credits resulted in the largest percentages of credit awarded to businesses in calendar years 1999-2003.

### **Evaluation Scope and Methodology**

The evaluation was focused on evaluating the internal controls over the administration and processing of tax credits at DOR. The evaluation did not address the roles of other agencies, such as DCA and DTAE, in the administration of tax credits. The tax credits selected for this review are those designed to recruit and expand business in the state, including credits designed to create and retain jobs. The 13 credits that meet this definition were established between 1989 and 2003. (These 13 credits are described on page 4.)

The evaluation was conducted in accordance with generally accepted government auditing standards for performance audits. The evaluation included fiscal years 1999-2004. The evaluation methodology included interviews with DOR staff, reviews of DOR files and reports, and analyses of tax credit data, and reviews of the various data systems used by DOR to track and record corporate tax credit information. The audit team also reviewed other states' reports, studies, and assessments.

This report has been discussed with appropriate personnel representing DOR. A draft copy was provided for their review and comment; pertinent responses have been included in the report as appropriate.

## Recommendations and Agency Responses

### Outcome Measurement:

#### The Impact of Corporate Tax Breaks

##### *Summary Assessment:*

*Our review revealed that data needed to assess how the state has benefited from awarding corporate tax credits is largely absent. For the credits selected for our review, statute does not require any data to be collected or reported by DOR or other agencies regarding these tax credits and their fiscal impact.<sup>2</sup> During tax years 1999-2003, the state awarded approximately \$284.5 million<sup>3</sup> in corporate tax credits without having any information regarding the resulting benefits.*

*As discussed in more detail in the data management section of this report, the limited data that is available is not reliable due to the fragmented nature of DOR's data collection systems and the lack of controls within the numerous systems used to track this basic information.*

### Recommendation No. 1

#### **Consideration should be given to collecting, reporting, and evaluating activity data related to tax incentive expenditures and outputs.**

Although DOR collects some tax credit data for administrative purposes (e.g., to track credits as they are earned, used, and carried forward for future use), there is limited aggregated data available for assessing the impact of credits as economic development tools. Statute does not require that information related to tax expenditures, such as tax credits, be reported for the 13 credits included in this review.<sup>4</sup> As a result, despite

**Tax expenditures** are tax dollars that are forgone through deductions, exemptions, exclusions, deferrals, **credits**, and preferential rates in tax laws.

<sup>2</sup> Through regulations established by DCA, however, DOR is required to annually report to DCA the number of jobs created by county/census tract area and by year through the job tax credit and the amount of tax credit used by all business enterprises.

<sup>3</sup> The \$284.5 million includes 12 of 13 tax credits evaluated as part of this review only. Information needed to assess the Job Tax Credit is tracked as required by DCA regulation and therefore not included in this dollar figure. Note that this figure is unaudited.

<sup>4</sup> It should be noted that the evaluation team did identify one tax credit (a credit for the rehabilitation of historic structures) for which statute requires reporting of economic impact.

some tax credits having been available for as many as 16 years, there is limited ability to determine their relative benefits or their effectiveness in achieving economic development objectives.

Examples of program output data that cannot currently be provided include the following:

- Value of investment property (total and by county/tier location) purchased by businesses earning the Investment, Optional Investment, and Port Traffic Investment Tax Credits.
- Extent to which businesses earning the Port Traffic Job Tax Credit or Port Traffic Investment Tax Credit increased port traffic.
- Number of employees trained by programs for which businesses earned the Basic Skills Tax Credit or the Retraining Tax Credits.
- Amount of income tax credits applied to withholding tax liability. *(Without this information, any reports regarding the use of tax credits will be understated.)*
- Amount of tax credits used by taxpayers that did not perform the qualifying activity (i.e., taxpayers that have used pass-through or assigned credit). *(This information is needed to report accurate credit use figures; without its inclusion, any estimates of credit use will be understated.)*
- Number of businesses and amount of tax credit used against corporate income tax liability (including businesses using pass-through credit), withholding tax liability, and individual income tax liability.
- Amount of outstanding tax credits available for use in future years against corporate income tax liability, withholding tax liability, and individual income tax liability.

In order to collect data needed for assessing corporate tax credits, DOR would have to change its record-keeping methods and database formats to allow for additional data elements to be collected and to make reporting of certain forms of aggregate data possible. (See pages 29-34 for a discussion of the data systems used to track and maintain tax credit information and recommendations for improving the controls over the data.)

*In its response to the report, DOR indicated that statute does not currently require the collection of data and that it believes the decision to collect and analyze tax credit data is a policy decision for the legislature's consideration.*

*DOR indicated that it would need to upgrade its data collection systems if it were required to report certain forms of tax credit data.*

## **Internal Controls**

### *Summary Assessment:*

*Our evaluation found that DOR has not adequately assessed the risks associated with the approximately \$114.2 million in tax credits that it administers on average in a given year. In addition, DOR has not developed a comprehensive system of controls to mitigate the risks associated with administering the credits. As just one small component of the overall corporate income tax filing process, corporate tax credits are not subject to systematic management or monitoring in order to prevent or detect problems with their overall administration. The current system of tax credit review relies primarily on one knowledgeable individual to approve or deny companies' eligibility and calculate the amount of credit that can be taken for the majority of the tax credits administered by DOR (with few controls to protect or guide this individual in making these decisions). As a result, we have little assurance that the system of controls over DOR's administration of corporate tax credits is adequate for ensuring that credits are approved and denied consistently and accurately.*

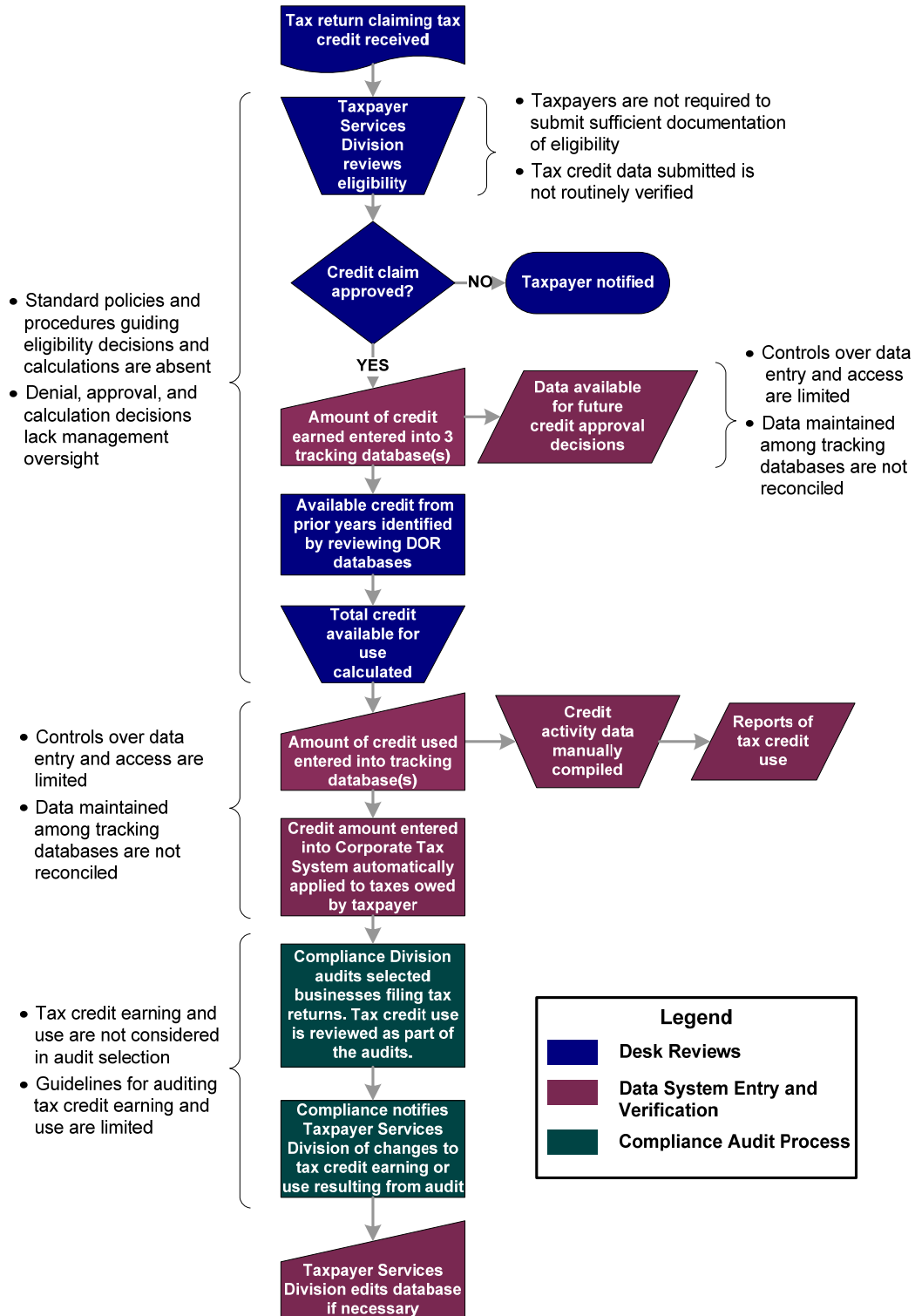
*Internal control improvements are needed in each step of the process: from the desk reviews of credits claimed on income tax returns to the audits of corporate tax credit use, to the databases that maintain tax credit data. Overall, DOR should reevaluate the entire system of controls over tax credits to determine the appropriate level of reliance that should be placed on the desk review process versus the corporate income tax audits to ensure that tax credits are approved and denied consistently and accurately.*

*The individual control weaknesses are summarized in the flow chart on the next page. A further discussion of these problems can be found on the pages listed below.*

- *Desk Reviews – page 17*
- *Auditing of Tax Credits – page 25*
- *Data Management – page 29*

## Exhibit 7

### Internal Control Weaknesses in the Tax Credit Administration Process





## **Desk Reviews of Tax Credits**

### **Control Assessment:**

*Although desk reviews serve as an important and necessary control in the overall administration of corporate tax credits, the reviews themselves lack important controls needed to ensure that DOR administers the credits consistently and accurately. Given the number of credits administered by DOR and the complexity of the credits, the risk of errors or misinterpretation by reviewers and taxpayers is high. DOR should develop standard policies and procedures for reviewing companies' eligibility and for calculating the amount of credit awarded, require better taxpayer documentation in support of credit claims, and employ some verification techniques to reduce staff's reliance on self-reported data and company certifications that all requirements have been met.*

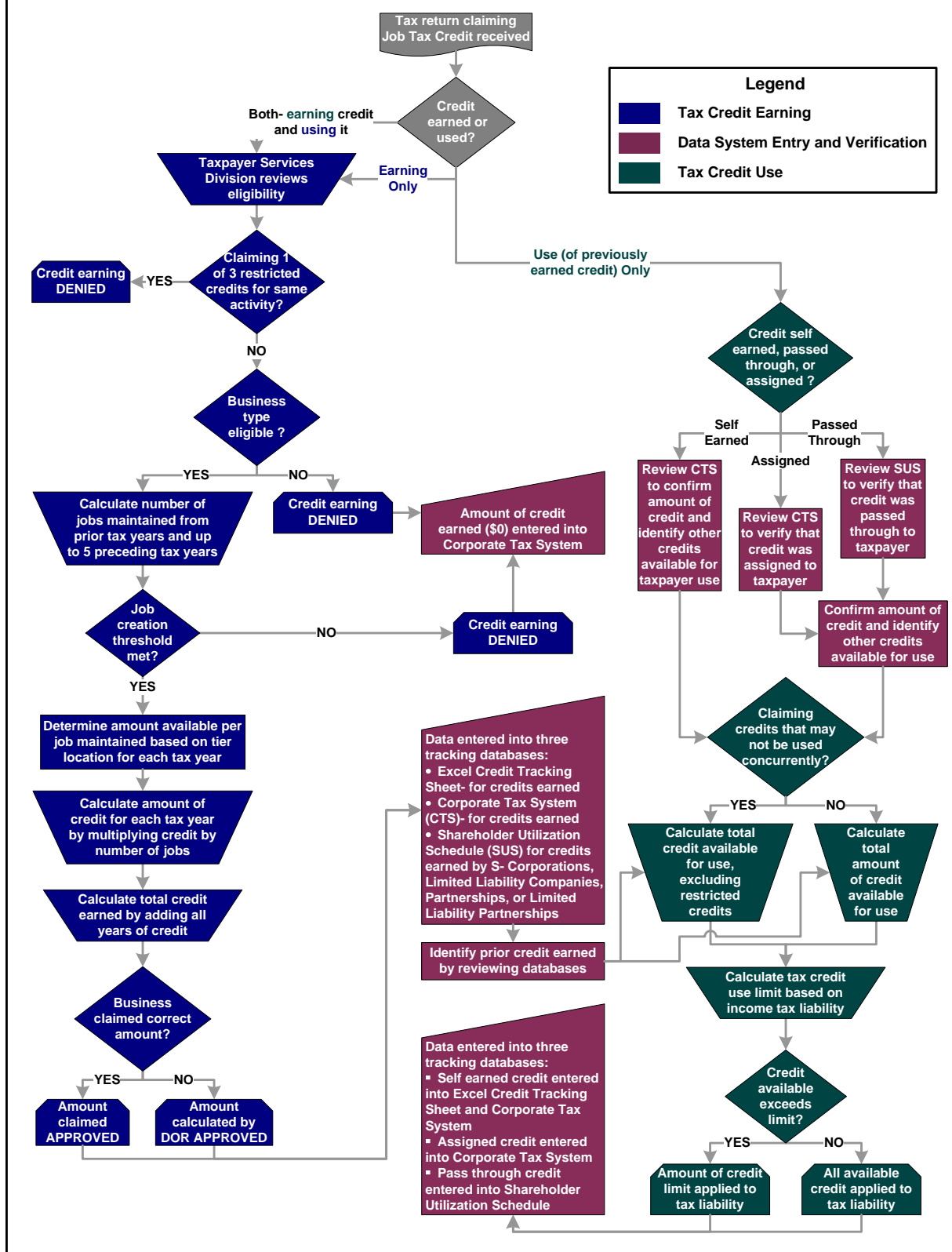
### **Recommendation No. 1**

**While DOR should be commended for establishing the desk review process, it should develop procedures regarding the method by which tax credits are reviewed and calculated.**

There are no written procedures currently in use to guide DOR staff in making decisions regarding business income tax credits when reviewing companies' earning or use of a credit. During a desk review, DOR staff determines whether a taxpayer is qualified to earn or use the credit and how much credit the taxpayer may use based on personal knowledge and interpretation of requirements and calculation methods included in statute and regulations. These decisions, however, are not periodically reviewed for accuracy and consistency. As a result, there is no assurance that these individual judgments are being made in accordance with state law and departmental regulations.

Because tax credit requirements are complex and because statutory guidelines are broad and unclear at times, there is an increased risk of misinterpretation and inconsistent treatment of taxpayers. To illustrate the variety of factors that DOR staff must consider in approving, denying, and calculating a tax credit, **Exhibit 8** on the following page shows the steps involved in processing a business' claim for the Job Tax Credit. As described on page 19 and 20, four factors contribute to the complexity of the desk review process and could lead to inconsistent and inaccurate application of statutory or regulatory guidelines.

## Exhibit 8 Job Tax Credit Review Process



- *Multiple Eligibility Factors:* Many of the statutory guidelines for tax credit eligibility have multiple components that must be considered when determining if a company is eligible for a given tax credit. These include minimum requirements for the activities related to the credit (e.g., number of jobs created); the differing amount of credit based on the location; and requirements for the type of business that can earn the tax credit.
- *Lack of Statutory Clarity:* Our review found a number of credits that have broad and/or unclear statutory language which increases the risk of inconsistent interpretation and application of requirements for determining eligibility and the amount of credit awarded. For example, statute for the Job Tax Credit, Research Tax Credit, and the Rapid Growth Tax Credit indicates that these credits are available to “business enterprises” that participate in business activities such as manufacturing and processing. While DCA has further defined specific activities that fit within these categories for the Job Tax Credit by linking standard industry codes to these definitions, DOR staff indicated that they use the DCA definitions to make eligibility decisions for the Job Tax Credit only. According to DOR staff, eligibility decisions for the Research and Rapid Growth Tax Credits are based on employees’ interpretations, which appear to be more restrictive than the DCA regulations. (See page 37 for more information about the “business enterprise” definition.)

Similarly, unclear statutory language regarding the calculation of the Cigarette Export Tax Credit has resulted in the inequitable award of tax credit among taxpayers. Because the statutory language is unclear, DOR has used two different calculation methods – one that places an upper limit on the amount of credit earned and one that places an upper limit on the amount that can be used (which is a less restrictive method than the former) - to determine the amount of credit awarded to taxpayers. Because DOR has not defined how this credit should be calculated, DOR staff members calculate the amount of credit earned by deferring to the taxpayer’s method of calculation. As a result, taxpayers are not being treated consistently. For example, the audit team found one business that had earned over \$5.2 million less credit than it would have if it had used the less restrictive calculation method.

- *Statutory Amendments:* Our review found that statutory guidelines regarding eligibility or credit calculation methods may differ across

tax years for the same credit due to amending legislation. As a result, DOR staff must be familiar with both old and new requirements and guidelines in order to review taxpayers' returns that claim and use credits in consecutive years. In addition, taxpayers may claim tax credits on amended returns up to three years after a given tax year. Additional problems associated with changes in statute for the Job Tax Credit are discussed on page 38.

- *Restrictions on Use of Credits:* Statute in some cases may also limit or restrict how a company may use credit it has earned. For example, statute may restrict concurrent use of certain tax credits or place limitations on the amount of credit used based on income tax liability. In addition, some credits have a limitation regarding the number of years in which the credit may be used and/or carried forward for future use. Statute may also allow supplements to some tax credit amounts if additional requirements are met (such as the port traffic and joint development authority supplements to the Job Tax Credit).

DOR should develop written procedures and/or regulations to guide staff in making decisions regarding the earning, calculation, and use of credits. By reducing the need for individual interpretation of statute and regulations by reviewers, DOR would reduce the potential for inaccurate interpretations being used to make credit eligibility decisions and calculations. Standardized guidelines are also needed to maintain reviewer consistency and to ensure that credits are awarded equitably among similar taxpayers.

*DOR indicated that it agrees with the recommendation and that it is drafting guidelines that will contain mandatory review procedures that require dual accountability so that two levels of sign off will be required on all credit decisions. In addition, DOR plans to develop an accompanying manual that will be a single source of applicable credit laws, regulations, and policy for all reviewers. DOR intends to implement these changes by October 1, 2006.*

## **Recommendation No. 2**

**DOR should consider requiring that businesses submit additional information of qualifying activities to better demonstrate their eligibility for a tax credit. DOR should also improve its verification of taxpayer certifications.**

Our review found that the information and documentation that taxpayers are required to provide in support of tax credit-qualifying activities are limited,

with staff relying on taxpayer certifications that tax credit requirements have been met. As a result, DOR's reviews of most tax credits primarily involve confirming the correct calculation of the credit amount rather than verifying that the activity occurred as reported. Two factors increase the potential for taxpayers to submit incorrect information when claiming tax credits: 1) taxpayers may misrepresent information to increase the amount of credit that they receive; and 2) the complexity of tax credit requirements increases the possibility that businesses may unintentionally claim tax credits for activities that are not eligible for the credit (e.g., a business may claim the Job Tax Credit for an ineligible job due to a misinterpretation of statute and regulations). Examples of the limited information and documentation requirements and the limited verification process are discussed below.

- *Job Tax Credit:* The Job Tax Credit is awarded for job creation and is calculated at a rate per new full-time employee. To qualify for the credit, the average wage of the new jobs must be above a certain amount, and health insurance must be made available to employees. When claiming the Job Tax Credit, a business is only required to submit a form that reports the total number of employees subject to Georgia income tax withholding. A business is not required to provide proof of insurance or a list of employees and their respective wages, nor is it required to submit information that demonstrates that the average wage of its new employees exceeds eligibility criteria for taking the credit. Without this information, DOR is making eligibility decisions based on minimal information. Given current requirements, it also cannot evaluate whether the average wage of the new jobs meets statutory requirements and ensure that the company offers health insurance coverage.

It should be noted that taxpayers are required to provide more complete documentation to claim the Headquarters Job Tax Credit, which also has a wage minimum. To claim this credit, taxpayers must submit a list of employees whose jobs are eligible for the credit, along with their wages and social security numbers.

- *Basic Skills Tax Credit:* Taxpayers claiming the Basic Skills Tax Credit are not required to submit documentation regarding the eligibility of the basic skills training program for which the credit is being claimed. Per statute, taxpayers are only eligible for this tax credit if they provide their employees with basic skills training that has

been approved by the Department of Technical and Adult Education (DTAE). Despite this, DOR does not require that businesses submit proof of DTAE approval with their tax credit claims, nor does DOR staff contact DTAE to verify that the training has been approved. Program staff indicated that they do not attempt to confirm DTAE approval because the audits conducted by DOR's Compliance Division will verify it. (See page 25 for more information regarding corporate income tax audits.)

It should be noted that taxpayers are required to provide more complete documentation to claim the Retraining Tax Credit. Like the Basic Skills Tax Credit, the Retraining Tax Credit also requires DTAE approval of all training programs for which the credit is claimed. To claim the Retraining Tax Credit, however, taxpayers must submit a training program completion form signed by DTAE.

- *Cigarette Export Tax Credit:* Information submitted by businesses claiming the Cigarette Export Tax Credit is not verified by DOR staff. According to statute, a taxpayer must submit a schedule listing monthly export volumes for the tax year. According to state law, these numbers should match the numbers submitted on the business' monthly reports to the Bureau of Alcohol, Tobacco, and Firearms (ATF) of the U.S. Department of the Treasury. However, DOR does not require that copies of these reports be submitted with the income tax return, nor does it validate the taxpayer-submitted figures by obtaining the reports submitted to the ATF. According to DOR staff, even if a business were to submit these reports, they would not be used in a desk review because staff is not required by statute to do so.

An increase in documentation requirements and/or taxpayer-reported information would provide DOR better, more complete information for assessing businesses' eligibility for and calculation of tax credits claimed on their tax returns and would improve its ability to conduct thorough and accurate desk reviews. If DOR relies less on taxpayer certifications, requires better information in support of tax credit claims, and independently verifies taxpayer information, it can minimize the risk of approving a credit based on misrepresented or erroneous information provided by the taxpayer. It is important to note that DOR relies on its Compliance Division to confirm the accuracy of information submitted by taxpayers during corporate income tax

audits. However, as discussed in the following section, the Compliance Division's role in reviewing tax credit eligibility is limited.

*In its response, DOR indicated that it disagrees that it should require additional supporting documentation to be filed when businesses claim a credit. According to DOR, "the Georgia legislature did not ask DOR in the original legislation to require this documentation as a precondition to obtaining a credit, though every taxpayer must provide documentation for all items on their return when requested on audit." DOR noted that "the desk review is not intended to be an audit of every single taxpayer that takes a credit. The desk review merely ensures that the required forms/agency approvals are included and that the taxpayers' representations are consistent with the qualifications for taking that particular credit..." "For taxpayer compliance purposes, a tax credit is viewed like any other taxpayer-reported item on a return..." Overall, DOR views tax credits as a small component of the overall corporate income tax filing process, amounting to .7% (\$114.2 million) of \$16 billion in tax revenues taken in annually.*

*In addition, DOR noted that DOR does not have statutory responsibility regarding eligibility guidelines for the Job Tax Credit and, therefore, has no direct control over the content of the form used by taxpayers to claim the Job Tax Credit. Nonetheless, DOR indicated that it would suggest to DCA that additional items be added to the form.*

### **Recommendation No. 3**

#### **DOR should implement a quality assurance process that includes periodic reviews of tax credit approvals, denials, and calculations.**

Currently, DOR does not have a system in place to find and correct inaccurate or inconsistent tax credit approvals, denials, and calculations that may occur during a desk review. Decisions regarding a taxpayer's eligibility, as well as the review of the credit calculation, are made by one individual and are generally not subject to supervisory review or a second level of review. Because decisions regarding businesses' tax credit eligibility are not subject to review and monitoring, DOR has no assurance that the tax credits are being used consistently and accurately; it does not know where errors exist, and therefore cannot correct them; and there is potential for tax credits to be awarded to businesses that have not met eligibility requirements.

Four individuals in the Tax Credits and Incentives Unit are responsible for

conducting desk reviews of tax credits. The Unit supervisor handles the review of companies' returns that involve the more complicated credits and delegates the review of the more straight-forward credits, such as the investment and retraining tax credits, to other staff. Although the Unit supervisor is considered to be the most knowledgeable regarding the tax credits and their requirements, she indicated that she does not periodically review the decisions made by her staff. Furthermore, the supervisor's manager does not spot check decisions made by the Unit supervisor or the supervisor's staff.

The Unit also completes desk reviews of tax credits (e.g., Investment Tax Credit, Optional Investment Tax Credit, and Port Traffic Investment Tax Credit) that have been pre-approved by a DOR staff person located in the Tax Law and Policy Unit. While this provides an opportunity for a second level of review, Unit staff only review credit eligibility for Port Traffic Investment Tax Credit claims. For the other pre-approved credits, staff indicated that they defer to the eligibility decision made by the individual pre-approving the credit and simply focus on "checking the math" on the taxpayer's return.

DOR should implement a quality assurance process that includes periodic reviews of tax credit decisions to ensure that approvals, denials, and calculations are accurate and consistent with DOR policy. Periodic reviews of staff approval decisions could also reduce the risk of fraudulent approval of tax credits. The review should be documented and the results evaluated to determine areas needing further clarification or interpretation. To make the most efficient use of its staff and time, DOR should consider conducting periodic reviews of tax credit decisions based on an internal risk assessment. Examples of factors that should be considered for review include: complexity of credit requirements or calculations; the experience of the reviewer; and the amount of credit claimed by the taxpayer.

*DOR indicated that it agrees that written procedures should be drafted to provide specific guidelines for review of staff decisions. In its response, DOR noted that the policies and procedures that outline the review process, the requirement for dual authorization, and the dollars and issues that will require progressively high levels of sign-off will be in place by September 1, 2006. It should be noted that staff reviewers are already required to obtain dual approval when taxpayers' requests for income tax refunds (based on new tax credit claims) reach certain dollar thresholds.*



## **Auditing the Use of Tax Credits**

### **Control Assessment:**

*There are only two points at which decisions to approve the earning and use of corporate tax credits could be reviewed by a second party – during a desk review of those credits that require pre-approval (only three credits) or during an income tax audit. Our review found, however, that these opportunities to reevaluate eligibility decisions made by other DOR staff are generally not taken and that the initial decision to approve a taxpayer's eligibility for a credit is not systematically reviewed as the credit moves through the process of being earned, used against tax liability, and audited.*

*The Compliance Division's corporate income tax audits currently serve as the final and most significant control within the overall processing and administration of corporate tax credits. However, our review found that there are limitations to this control. Audit data indicates that a small fraction of the businesses claiming corporate income tax credits are audited in a given year. In addition, reviews of audit documentation and interviews with Compliance Division staff revealed uncertainty regarding the extent to which a company's eligibility for a credit is reviewed at the time of the audit. Staff also revealed concerns regarding their understanding of the numerous credits and their requirements.*

### **Recommendation No. 1**

**DOR should take steps to determine the appropriate level of reliance that should be placed on corporate income tax audits for ensuring that tax credits are approved or denied consistently and accurately.**

Given the minimal requirements for providing supporting documentation in order to claim a credit on a tax return, much of the burden for determining whether credits have been properly earned and claimed falls on DOR's corporate income tax auditors. Interviews with TPS Division staff and management (who conduct desk reviews of tax returns claiming tax credits at the time the returns are submitted) indicate that there is an assumption that the Compliance Division's business tax audits serve as an adequate check or control in the tax credit process. However, only a small fraction of the credits used by businesses are audited.

At the request of the evaluation team, DOR staff helped to estimate the proportion of credits claimed that were audited by matching audit data maintained in the Compliance Division's database to tax credit data

maintained by Taxpayer Services Division. According to this analysis, approximately 8% (314 of 3,895) of the credits claimed during calendar years 1999 and 2000 were audited. Overall, it is estimated that only about 1.6% of the approximately 93,475 corporate income tax returns filed each year are audited (which includes tax returns that claim credits and those that do not). It should be noted that there is no mechanism in place for tracking the percentage of businesses that claim tax credits that are audited or the total number of businesses submitting tax returns that are audited.

Although the Compliance Division selects companies for audit based on several criteria and attempts to audit businesses at least once every three years, companies are not selected for audit on the basis of having used tax credits against their tax liability. Division staff indicated that businesses with larger tax liabilities are audited more frequently, and that these businesses typically are those that use tax credits.

DOR should take steps to determine the level of reliance that should be placed on audits conducted by the Compliance Division to ensure that business income tax credits are properly claimed and used. If it is determined that the income tax audits conducted by the Compliance Division are to be heavily relied upon as a control, DOR may need additional resources in order to increase the number of audits conducted. Additional consideration should be given to using tax credits as part of the audit selection criteria. As discussed in the following Recommendation, the Compliance Division should, at a minimum, develop procedures for reviewing the businesses' eligibility for tax credits and obtaining verification in support of credits claimed by businesses.

*DOR noted in its response to the report that it will continue to rely significantly on audits as a control to ensure the proper claiming and use of tax credits, just as it relies on audits as a control with respect to each item reported on a taxpayers return. DOR indicated that it feels that the percentage of taxpayers claiming a credit who were audited compared favorably to the overall percentage of taxpayers audited. Even though tax credits appear to be fairly represented using DOR's current audit selection methods, DOR indicated that it would add tax credit thresholds to its audit selection criteria. DOR also reported that it has developed a special credits audit program that has been used over the past year and a half that has generally resulted in few adjustments to tax credits used by taxpayers. Per DOR, the reviews using the special credit audit program resulted in the*

*following adjustments:*

- 71 Investment Tax Credit audits resulted in total assessments of \$8,094;
- 48 Job Tax Credit audits produced a single assessment of \$76,384 (with 47 yielding no change);
- 33 Research Tax Credits resulted in three assessments totaling \$149,740.

*(It should be noted that the Department of Audits did not verify the content of the reviews (e.g., whether auditors reviewed businesses' eligibility for the credits), the extent to which the results or the number of reviews completed are representative, or the time frame to which these findings apply.)*

## **Recommendation No. 2**

**The Compliance Division should continue its efforts to develop audit guidelines to ensure consistent and thorough audit reviews of tax credits used by businesses.**

During a corporate income tax audit, reviews of tax credits consist primarily of verifying that a company can support the information it submits on its tax return to obtain a credit. For example, to verify a jobs tax credit, the auditor will look at a business' payroll records to confirm employment numbers submitted on the tax return in order to claim the credit. Interviews with Compliance Division staff, however, indicated that their auditors generally do not question a business' eligibility for a credit during an audit because they lack the guidance and expertise needed to adequately check decisions made during DOR's desk reviews. In addition, there were no written guidelines for obtaining the necessary documentation to verify a business' eligibility for a credit and identifying problems with documentation. A review of documents that at one time had been given to Compliance Division auditors revealed that the documents were out-dated and contained only minimal guidance concerning the calculation of certain credits. As a result, the extent to which auditors can identify problems with supporting documentation or businesses' eligibility is dependent on each auditor's understanding of statute as well as his/her experience.

During the course of this evaluation, a Compliance Division supervisor began developing guidelines for reviewing businesses' use of tax credits during a corporate income tax audit. Prior to this, no such written procedures existed and the extent to which credits had been reviewed was not clear based on a sample of audit files reviewed by the evaluation team. A review of the

preliminary audit guidelines revealed some general steps to be taken while reviewing certain tax credits as well as guidance in obtaining supporting evidence for some of the credits included in the scope of this evaluation. Several steps also appear to be designed to verify several aspects of eligibility for credit, such as the location of the business or approval by another administering agency. The guidelines, however, did not appear to address all the eligibility factors that should be considered. For example, for the Job Tax Credit, there are no guidelines specifically related to determining if the wages of the new jobs exceed the average wage of the county and whether health insurance is made available to employees.

To ensure consistent and thorough reviews of credits during an income tax audit, guidelines should be developed for reviewing eligibility decisions and for ensuring proper support for business tax credits. The Compliance Division should continue its efforts to standardize corporate tax credit reviews and develop a set of comprehensive guidelines. Consideration should also be given to the Compliance Division's role in serving as a second level review on tax credit eligibility decisions.

*In its response to the report, DOR indicated that it agrees with this recommendation. Specifically, DOR indicated that a worksheet for collecting information needed to ensure the accuracy of tax credit information contained on a business' tax return will now be provided to taxpayers at the beginning of an audit. In addition, the Compliance Division is developing a training module that will provide staff auditors with the knowledge required to audit this increasingly complex area. "Refresher/up-date" training will also be provided to staff annually.*

## **Data Management**

### **Control Assessment:**

*DOR should make improvements to its data systems to provide more reliable information regarding tax credit activity and to allow for better monitoring and evaluation of tax credits. Our evaluation found that DOR lacks a centralized information system needed to maintain and monitor data related to tax credits. To compensate for the limitations of the Corporate Tax System and other official systems, staff have created their own off-line systems to facilitate the tracking of the numerous tax credits DOR administers. These systems, however, lack controls and are not monitored or reviewed for accuracy. In total, there are six systems in place, including three official tax systems and three off-line systems, which contain various components of tax credit information. Because of the fragmented nature of DOR's record-keeping and the lack of adequate controls within the data systems used, basic activity data regarding the earning and use of credits is of questionable accuracy and reliability.*

### **Recommendation No. 1**

**To facilitate better management of tax credits and to collect information needed to assess tax credits, DOR needs to develop a better data management system.**

There is not a centralized data management system in place that can be used to adequately track, monitor, and maintain tax credit information. The current system used to collect and maintain tax credit information is fragmented – involving six different databases each containing various aspects of tax credit information. While some overlap in data exists among the systems, none can stand alone (due to their design and content) to provide complete information regarding credit earning, use, and related approval decisions. As a result, DOR is unable to compile accurate aggregate data that is necessary for internal review and legislative decision-making.

Currently, DOR staff use three official data systems and three off-line databases to maintain and track tax credit information. Because DOR's official data systems — the Corporate Tax System (CTS), Withholding Tax System (WTS), and Individual Income Tax System (IITS) — do not contain data necessary for tracking tax credit transactions and guiding desk review decisions, DOR staff have created additional databases. These databases include Excel Tracking Sheets, Shareholder Utilization Schedules, and the Withholding Access Database.

Because none of the databases can stand alone to provide complete information, basic data elements are not easily aggregated and can only be attained through manual compilation of individual records in multiple data systems. Four databases — CTS, Excel Tracking Sheets, SUS's, and IITS — maintain different components of data regarding the earning and use of Income Tax Credits. Similarly, four separate systems — WTS, CTS, Withholding Access Database, and Excel Tracking Sheets — maintain different components of data regarding the earning and use of Withholding Tax Credits. **Exhibit 9** shows the various types of data maintained by the six databases.

Exhibit 9								
Tax Credit Data Maintained in Data Systems								
		Data Systems						
		Data Maintained	CTS	Excel Tracking Sheets	SUS	IITS	WTS	Withholding Access Database
Taxpayer Type	Business	Earning	•	•	•			•
		Use	•	•	•		•	
		Denial of Earning						
	Shareholder Corporation	Earning	•		•			
		Use- passing through to shareholders	•		•			
		Denial of Earning						
	Individual	Earning			•			
		Use (Receipt of Pass-Through Credit)			•	•		
		Denial of Earning						

The fragmented nature of the data has resulted in an inefficient desk review process and has limited DOR's ability to effectively manage the tax credits overall. In order to conduct desk reviews, DOR staff must consult multiple data systems to verify and record tax credit earning and use information. For example, in order to approve a shareholder claiming credit passed through from a business, DOR staff would have to use CTS, SUS's, and IITS to verify the amount being claimed and to record the amount being used by the shareholder.

DOR also lacks information needed to review the efficiency and effectiveness

of tax credit administration. Examples are provided below:

- Because data regarding the number of taxpayers claiming each type of tax credit is incomplete, DOR cannot determine the number of desk reviews conducted within a certain time frame. Without this information, DOR cannot evaluate the adequacy of resources devoted to tax credit reviews.
- None of the databases tracks credit claims that have been denied by DOR staff. (Such information would allow for workload analysis as well as provide a starting point for periodically reviewing staff eligibility decisions for compliance with statute and regulations.)
- Activity data for assessing tax credits' fiscal and economic impact is not maintained for most of the credits reviewed. Examples of this basic activity that is not tracked include: dollar value of investment, number of employees trained, average wage of jobs created, etc.
- There are a number of data elements that are tracked but not easily aggregated. For example, in order to calculate the amount of outstanding income tax credit available, data would have to be obtained from CTS or Excel Tracking Sheets and SUS's.

DOR should evaluate its official data systems to determine if they can be further developed to capture the various data elements needed to track credits in a central system. However, the evaluators are aware that this would require additional time and resources. In the meantime, DOR should take steps to improve the internal controls over the various official and off-line databases (as discussed in more detail in the following Recommendation).

*DOR indicated in its response that its Information Systems Division personnel are working to improve and integrate its management systems, but as noted above, this will occur over time and will require additional resources. In the interim, DOR indicated that it will implement the controls over these databases as recommended in this report.*

## **Recommendation No. 2**

**To ensure accurate and reliable data, DOR should implement stronger controls over data systems used to track and maintain corporate tax credit information.**

In addition to being highly fragmented, our review found that DOR's data management system has few controls in place to ensure the accuracy and reliability of the data maintained in the six systems that comprise it. The

official data systems, such as CTS, have adequate controls built in; however, they do not store much of the tax credit data needed for tracking and reporting purposes. The off-line databases created and maintained by staff do not have the controls needed to ensure the integrity of the data. In addition, the entry of duplicate data into multiple data systems increases the possibility for data entry errors to occur. In addition, there is no reconciliation of the data among the databases to ensure that information is consistent, accurate, and up-to-date. As a result, information maintained and reported by DOR regarding tax credits has questionable accuracy and reliability, as it is gathered from systems that do not have adequate controls over the data maintained in them.

As shown in **Exhibit 10**, the off-line, Excel databases (Excel Tracking Sheets and SUS's) used to maintain corporate tax credit information do not have any controls over data entry and do not provide audit trails. For example, the Excel databases do not contain standardized data entry fields to limit data entry errors. There are also no built-in flags to alert staff to potential conflicts such as if the amount of the tax credit used exceeds the tax liability. DOR staff are also not able to track changes to data maintained in Excel. Although Excel databases can be password-protected to prevent unauthorized users, staff do not currently use this function, leaving the data contained in them vulnerable to changes and raising questions regarding the confidentiality and security of taxpayer data.

Exhibit 10		
Controls in Data Systems Used to Track Tax Credits		
Official DOR Data Systems	Off-line Databases	Controls Available
<b>General System Controls</b>		
✓	✓	Ability to limit who has access to the system
✓	✓	Ability to limit the type of access each individual has within the system (including read and write access)
<b>Input Controls</b>		
✓		Standardized data fields and inputs
✓		Error warnings
<b>Output Controls</b>		
✓		Audit trails for tracking changes made within the system



It should also be noted that although CTS has more controls than the other off-line systems, its functionality is not always used to its fullest potential. For example, CTS has the ability to track changes made in the system; however, changes to tax credit data fields are not regularly monitored. As discussed on pages 23-24, periodic review and reconciliation of data is needed to ensure the accuracy of information in the system and to deter/detect fraudulent activity.

Examples of the problems associated with the duplication of some data elements among several databases and the lack of computer controls and oversight are discussed below:

- Tax credit data maintained by DOR varies depending on the system in which it is maintained. In a review of taxpayer files, we found discrepancies among figures listed in data systems that should contain the same data. For example, when comparing figures in CTS to figures in Excel Tracking Sheets for a sample of tax credit transactions, DOR had differing amounts of tax credit use across the data systems for 32% (10 of 31) of the businesses sampled. For these ten records, there was a difference of over \$1.5 million in credit between the two systems. As a result of these problems, it is reasonable to conclude that figures that DOR has reported regarding dollars of tax credit used and number of businesses using tax credits (and included in this report on pages 1, 10, 12, 15, and 35) are inaccurate.
- The audit team also found other examples of data entry errors during this review in both the official and off-line data systems:
  - ✓ Duplicate data regarding a business' credit earning was entered into CTS, resulting in the business having double the amount of credit it had earned available for use.
  - ✓ Records of a business' tax credit use were mistakenly recorded in an Excel Tracking Sheet for a credit it had not used. Any estimates of credit use compiled from the spreadsheets for these credits would be either understated (for the credit type actually used) or overstated (for the credit type that had not been used).
  - ✓ Incorrect classification of business type.
  - ✓ Misspelled business name, resulting in a single business having multiple listings and possibly multiple credit amounts.
  - ✓ Credit amounts that are in conflict with statutory limits on the amount of credit that can be earned.

Periodic reconciliation of data maintained in the official and off-line data systems would allow DOR to identify errors and to ensure that each is up-to-date and accurate.

DOR should ensure that databases used to track and monitor corporate tax credits contain adequate controls over the data maintained in them. These should include system, input, and output controls (including a secondary review over data entry). By implementing these controls, DOR can better ensure the accuracy of the data it maintains for making informed management and policy decisions.

*DOR indicated that the control issues discussed here are being addressed immediately. DOR is drafting mandatory procedures to require the use of controls, such as password protection, standardization of data entry fields, data conflict rules, etc., while the off-line databases continue to be used.*

## For Consideration by the Governor and the General Assembly

### Recommendation No. 1

**Consideration should be given to revising statute to require the collection and reporting of data related to tax incentive expenditures, outcomes, and outputs.**

Georgia has forgone at least \$284.5 million<sup>5</sup> in potential income tax revenue due to tax credit use from 1999 through 2004 with little indication of any economic development benefits resulting from these tax expenditures. Statute does not require that data associated with the 13 corporate tax credits

**Tax expenditures** are tax dollars that are forgone through deductions, exemptions, exclusions, deferrals, *credits*, and preferential rates in tax laws.

reviewed as part of this evaluation be collected or reported. As a result, corporate tax credits are not subject to the same level of accountability despite their having the same fiscal impact as direct program expenditures.

According to a 2005 report, “Accountability for Economic Development Incentives in Georgia,” published by Georgia State University’s Fiscal Research Center, Georgia is one of only 12 states that do not require any form of tax expenditure reporting. The report defines tax expenditures as “tax dollars that are forgone through deductions, exemptions, exclusions, deferrals, *credits*, and preferential rates in tax laws.” Although they are not direct fund expenditures, tax expenditures have the same fiscal impact because they reduce revenue available for use by other state programs. As noted in the report, the implementation of statutory reporting requirements of tax expenditures in states such as Minnesota, Maine, and North Carolina has “resulted in reports, recommendations, and changes to the states’ laws.” Examples of the reporting requirements in two other states are provided below.

- *North Carolina:* The North Carolina Department of Revenue is required to publish biennially a report that includes, by credit and by taxpayer, the number of claims for each credit; the number and tier area of new jobs created as the result of a tax credit earned/used; the cost and tier area of property investment for which credits were earned/used; the amount and tier area of research and development expenditures for which credits were earned/used; the amount and tier

<sup>5</sup> The \$284.5 million includes 12 of 13 tax credits evaluated as part of this review only. Information needed to assess the Job Tax Credit is tracked as required by DCA regulations and therefore not included in this dollar figure. Note that this figure is unaudited.

area of training expenditures for which credits were earned/used; and the number of jobs created by businesses located in less-developed zones and the percentage of jobs at those locations that were filled by residents of the zones.

North Carolina's Department of Commerce is required to compile a biennial equity study and an impact study. The equity study includes information regarding whether expanding in-state businesses receive fewer benefits than out-of-state businesses that relocate in North Carolina. The impact study evaluates the effectiveness of the tax credits, and includes a cost-benefit analysis, a description of other states' use of incentives, and an analysis of economic recruitment data.

- *Maine*: Four state agencies are required to submit reports to the legislature regarding the tax incentives that they are responsible for administering. The reports include the amount of incentives awarded and describe the public benefit associated with their use.

Consideration should be given to directing DOR to collect and report data for evaluating the fiscal and economic impact or the costs and benefits associated with providing corporate tax credits. In addition, the General Assembly should identify the objectives of the state's corporate tax credits; determine what tax credit activity data is needed for decision making; and, consider revising statute to require reporting by DOR. If DOR were required to report tax credit data, the General Assembly would be able to determine whether certain tax credits are an effective use of state resources and make any legislative changes to current tax credits that it deems necessary. In order to collect information to assess tax credits, additional resources may be needed to expand the capabilities of DOR's official data systems. (See pages 29-34 for a discussion of problems associated with DOR's data systems.)

*DOR agrees that revising statute to require the collection and reporting of tax credit data would be beneficial and that such a reporting requirement would require additional resources to expand the capabilities of DOR's official data systems. According to DOR, the state of North Carolina authorizes payment to its university system to compile the tax credit data.*

## **Recommendation No. 2**

**The Governor's Office and/or the General Assembly should take steps to clarify how the term "business enterprise" should be interpreted for the purpose of awarding tax credits.**

Although the Job Tax Credit (JTC), Research Tax Credit, and Rapid Growth Tax Credit all have similar statutory language regarding the types of businesses that are eligible to take the credit, DOR is making business eligibility decisions for the Research Tax Credit and the Rapid Growth Tax Credit that are in conflict with regulations established for the Job Tax Credit.

Per statute, eligibility for the three tax credits is limited to "business enterprises" which are defined as "any business or the headquarters of any such business which is engaged in manufacturing, warehousing and distribution, processing, telecommunications, tourism, and research and development industries . . . [and] shall not include retail businesses". Although DOR is generally responsible for administering tax credits, DCA is responsible for setting guidelines for the Job Tax Credit. Because the statute does not specifically detail the specific business activities that comprise these general categories, DCA further defined these activities in its Job Tax Credit regulations and has linked standard industry codes (from the North American Industry Classification System) and activity descriptions to these definitions. In contrast, DOR has not further defined what constitutes these general activities in its regulations regarding business income tax credits.

According to DOR staff, it would like to use a more restrictive definition of eligible activities when administering the two tax credits that DCA does not have statutory authority over. However, DOR staff noted that the State Attorney General's office has indicated that it may not formally create and implement a regulation re-defining a business enterprise because it would be in conflict with a definition that is already in use (i.e., DCA's definition located in its regulations). Despite this guidance, DOR has not used DCA's definition when determining eligibility for the two tax credits solely administered by DOR. As a result, a business that is eligible for the Job Tax Credit may not be eligible for the Research or Rapid Growth Tax Credits.

By clarifying the interpretation of the term "business enterprise," the Governor's Office and/or the General Assembly can better ensure that the Research and the Rapid Growth Tax Credits are being administered in accordance with legislative intent. To improve the administration of the tax

credits, DOR should develop regulations and internal procedures to allow for consistent treatment of taxpayers. New regulations would also increase transparency of the tax credit approval process/requirements for taxpayers.

*DOR noted in its response that it is working with the Governor's Office and DCA to agree on a uniform definition of "business enterprise" to eliminate inconsistent treatment of taxpayers going forward. If DOR and DCA are not able to substantially resolve the issue, DOR indicated that it will make specific recommendations for legislation prior to the next regular legislative session in 2007.*

### **Recommendation No. 3**

**The Governor and the General Assembly should provide direction to DOR regarding how it should implement the provisions of the 2000 amendment to the Job Tax Credit. Legislative intent should be clarified and DOR should amend its regulations, forms, and/or approval procedures to describe a method for calculating the credit that reflects this intent.**

In addition to having differing definitions of a "business enterprise," DOR and DCA also have differing interpretations of how a 2000 amendment to the Job Tax Credit (effective January 1, 2001) should be implemented. The method used by DOR to calculate the amended Job Tax Credit is not formally defined in statute, regulations, or internal procedures and, therefore, has not been made available to taxpayers. As a result, some taxpayers have protested DOR's decisions to deny credit claims and DOR staff has placed these tax returns with disputed credit claims "on hold" awaiting clarification of statute (some tax returns have been held since 2002). DOR staff has also calculated the credit claims in the 2002 tax year inconsistently among taxpayers.

The amending legislation established a fourth tier of counties based on their relative economic condition and altered the rate of credit, limitations on credit use, and minimum job creation requirements. In particular, the change in the minimum number of jobs that must be created to be eligible for the credit is the source of the differing interpretations between DCA and DOR. Specifically, the amending legislation reduced the job creation threshold required for eligibility (i.e., minimum number of new jobs needed to begin earning credit) for Tier 2 and 3 counties (from 15 to 10 jobs in Tier 2 and from 25 to 15 jobs in Tier 3); and established a job creation threshold for Tier 4 counties.

The difference in interpretation of the legislation affects the amount of credit a company receives, with DOR awarding a taxpayer less credit than DCA would. In a joint letter to the Office of the Governor on December 18, 2003, DCA and DOR state that the primary area of contention is the counting of jobs eligible for the credit that are created after 2000 but before a business meets the new job creation threshold. According to the letter, DOR considers jobs created after January 1, 2001 that do not meet the minimum threshold to be ineligible for the new credit amounts and new income tax liability limits, while DCA considers the jobs to be eligible. The letter requested assistance in clarifying how to implement the amending legislation. According to DOR staff, they have not received a response to this letter.

DCA has created regulations that address its interpretation of legislation. However DOR uses its own, more limiting interpretation of the legislation instead of the interpretation included in DCA's regulations but has not created regulations or internal procedures that define how it interprets the legislation. In addition, DOR has not revised its Job Tax Credit form to notify taxpayers of how it has decided to apply the amended statute.

DOR has also calculated the affected Job Tax Credits inconsistently. According to TPS staff, DOR's current policy is that a business is ineligible to earn any credit for jobs created in tax year 2001 or later if those jobs do not meet the minimum threshold for the number of jobs created. However, in a review of TPS files, the audit team found cases in which credit was approved for jobs not meeting the threshold and was used by the taxpayer. This inconsistency and the procedural changes have resulted in the inequitable award of the credit to taxpayers.

By clarifying the intent of this amending legislation, the General Assembly can better ensure that DOR is implementing statute appropriately. Once this clarification is received, DOR should also amend its regulations and develop internal procedures that describe the interpretation for staff and taxpayers. In addition to helping ensure accurate implementation of statute, the development of regulations would also increase transparency of the tax credit approval process for taxpayers.

*DOR has indicated that it agrees that clarification of this issue is important and that it is currently working with the Governor's Office and DCA to resolve it.*

#### Performance Audit Operations Division

Established in 1971 as part of the Department of Audits and Accounts, the Performance Audit Operations Division conducts in-depth reviews of state programs. The purpose of these reviews is to determine the degree to which state-funded programs are accomplishing their goals and objectives; provide measurements of program results and effectiveness; identify other means of achieving goals and objectives; evaluate efficiency in the allocation of resources; and assess compliance with laws and regulations.

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